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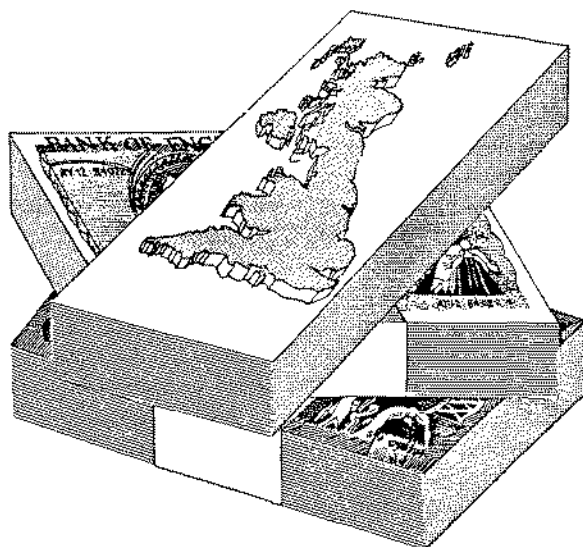
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The British Economy



OVERVIEW

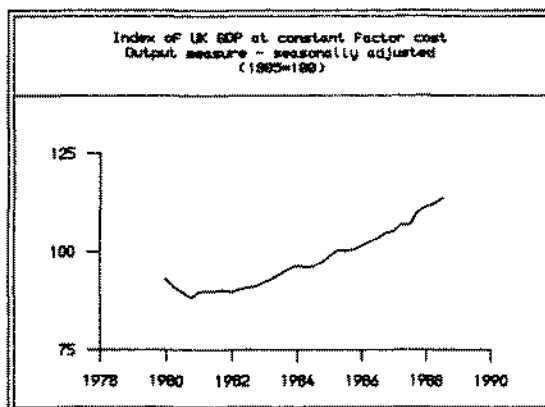
Evidence is mixed on whether growth in the economy is beginning to turn down. Nevertheless, the growth of GDP is forecast to fall from last year's high of 4.5% to 2.5% this year. Inflationary expectations are the most immediate cause for concern. But following the Budget there is concern that a relatively restrictive fiscal stance may bear down too heavily on output and employment during the next year.

MACROECONOMIC TRENDS

The estimates of GDP based on three independent measures: expenditure, income and output, have recently begun to show wide discrepancies. The expenditure measure in particular has moved significantly out of line. The CSO believes that a decline of 3% in constant price terms in this measure between the second and third quarters of 1988 indicates serious under-reporting. Accordingly, the CSO has based its estimate of the average measure of 'real' GDP and 'money' GDP on the output and income based measures, respectively. This is offered as a temporary

solution until the reasons for the discrepancies between the measures are discovered.

The average measure of GDP at current market prices, nominal or 'money' GDP, was 10% higher in the third quarter of 1988 than in the same period of 1987. This is broadly the same as the annual rate to the second quarter. After allowing for price changes, the average measure of GDP at constant market prices was provisionally estimated to have been 3.5% higher than a year earlier. This annual rate which is lower than that reported in the last Commentary of 4% to the second quarter is considered to reflect the erratically high growth in the average measure in the year to the third quarter of 1987. Real GDP is estimated to have increased between the third and second quarters of 1988 by 1%, compared with a 0.7% increase between the first two quarters of the year. Provisional estimates of output-based GDP for the fourth quarter of 1988 suggest that there was almost no change on the preceding quarter so that the measure stood at 3.5% above the level recorded a year earlier.



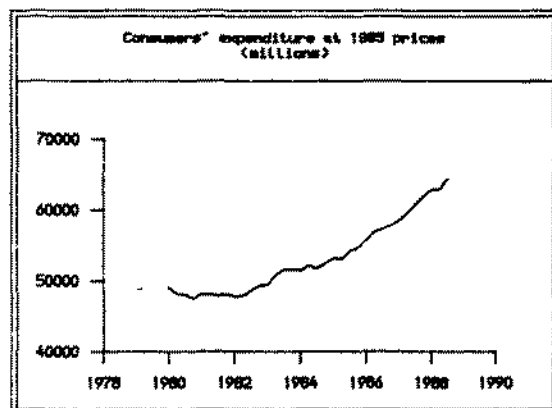
The GDP figures are therefore very difficult to interpret. The Treasury estimates that real GDP grew by 4.5% during 1988 and very few forecasters would disagree with that view. The provisional evidence from the turn of the year might indicate that the rate of GDP growth was slowing due to the effect of the interest rate rises, but this still needs to be confirmed. The CSO's coincident cyclical indicator, which attempts to show current

turning points in the business cycle around the long-term trend, has shown some decline since mid-1988.

In view of the concern about the accuracy of the expenditure estimates of GDP the measures of the components of that aggregate must be viewed with suspicion. Real consumers' expenditure is estimated to have risen by 2% between the second and third quarters of 1988 to a level 6% above the same period in 1987. This suggests a faster rise than in previous quarters where increases of 1.5% and 0.5% were recorded during the first and second quarters, respectively. In the third quarter, expenditure on most types of goods increased with the exception of outlays on food. The biggest increase occurred in expenditures on durables which rose by 14% between the third quarters of 1987 and 1988. This included a 22.5% rise in outlays on vehicles. Preliminary estimates of real consumers' expenditure for the fourth quarter of 1988 suggest that there was an increase of almost 1.5% over the level of the third quarter. The fourth quarter level of spending is therefore estimated to be 5.5% above the fourth quarter of 1987. For 1988 as a whole, the provisional estimate is of a 6% increase in spending over 1987.

There is, therefore, little in these figures to suggest that consumers' expenditure was slowing down by much towards the end of last year. The preliminary figures could, nevertheless, be revised downwards, although this appears unlikely given that the growth in the volume of retail sales appears to parallel the consumers' expenditure figures with both showing an increase of 5.5% in the year to the fourth quarter. However, the DTI's retail sales figures for January indicate a 2.4% fall in sales volume on the December level after adjustments for seasonal variations. Further evidence of a slowdown in consumer spending is provided by the data for retail sales in the three months to January which show no change on the previous three months. The CBI/FT distributive trades survey for February also show retail sales to be rising only slowly, indeed at the slowest rate for at least five years. A balance of only plus 12% of respondents reported an increase in sales compared with the same month in 1987. This figure was lower than any month previously on record and compares with plus 24% in January and plus 60% last summer. Unfortunately, after what appeared to be fairly solid evidence that consumer spending was turning

down in response to the higher interest rate regime, the February DTI retail sales figures pointed in the opposite direction. The index went back to the December level of 140.8 an increase of 2.5% from the January level of 137.4. However, the February data are only preliminary and given the direction of recent revisions it is very likely that the final retail sales figures for February will be revised downwards. Moreover, even on these preliminary data, sales volumes show no change over the December-February period compared with the preceding three months.



The evidence on the underlying determinants of the growth of consumer demand are now generally tending to point in the same direction. The growth in average earnings was provisionally estimated to be 8.75% in the twelve months to December 1988. This represents a fall from the peak 9.25% recorded in the twelve months to August and September. There is clear evidence here then of some slight moderation in a key determinant of consumer demand. Real personal disposable income (RPDI) rose again in the third quarter by 2.2% after the fall of 1.8% between the first and second quarters. Overall, RPDI is expected to have risen by 3% in 1988 on 1987 but the increase in 1989 is expected to be lower than that, probably by as much as one percentage point. Finally, the growth in consumer credit continues to slow. After a recorded net increase in the first quarter of 1988 of £965m, seasonally adjusted consumer credit increased by £1105m in the second quarter but growth reduced in the remaining quarters of the year with increases being posted of £1092m and £873m, respectively.

General government final expenditure, in real terms, fell by 0.5% in the third quarter of 1988

to a level 0.5% lower than the same quarter of 1987.

Gross fixed investment, at constant prices ie. in real terms, fell by 4% in the third quarter of last year following the increases in the two preceding quarters of 4% and 3.5%, respectively. By the third quarter the level of investment is estimated by CSO to have been 5.5% higher than a year previously. In view of the boom in investment spending during 1988 which is evident from other data it is almost certain that investment spending, in the second half of 1988 at least, has been under-recorded in the national accounts. Provisional figures from the DTI in February indicate that the volume of manufacturing investment rose by nearly 10% in 1988. Investment in new vehicles grew by 18.5%, which parallels the significant growth in consumer spending on vehicles. Spending on new plant and machinery rose by 10.5% while investment in buildings fell by 1.5%. In other sectors, preliminary estimates suggest that investment rose by more than 9.5% in the construction, distribution and financial sectors. However, if the evidence from the CBI's survey data is considered, along with the DTI's investment intentions survey and the strong growth of capital goods imports that can be detected in the trade figures, it is likely that investment growth was significantly higher during 1988 than current government figures suggest.

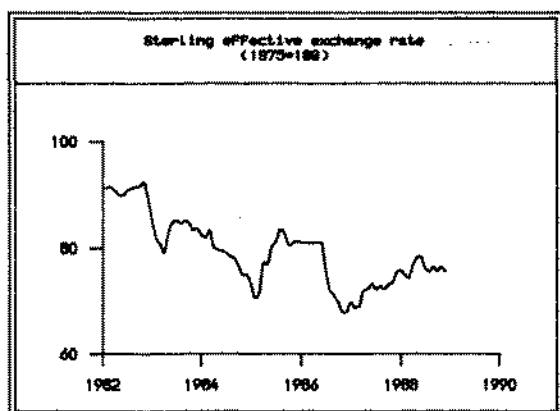
1988 saw a market deterioration in the current account as the severe demand pressures on UK productive capacity last year spilled significantly into imports. The estimated deficit of £14.7bn compares with a deficit of £2.9bn in 1987 and a small surplus of £0.15bn in 1986. The large positive balancing item in the balance of payments accounts should be noted. The balancing item of £15.2bn, compared with £12.4bn and £13.7bn in 1987 and 1986, indicates that there are errors and omissions of net inflows over both the current and capital accounts. The CSO believes that the balancing item is likely to reflect errors and omissions in the estimation of transactions affecting the capital account but acknowledges the possibility that net current account inflows are being underestimated. In other words, the current account deficit could be lower than presently estimated and in the unlikely event that under-recording of net exports of goods and services fully accounts for the discrepancy, there could have been a small surplus on the account last year. However, it is the change in the current

account deficit, or surplus, rather than the level which is the more appropriate indicator of trade performance and the build-up of inflationary pressure in the economy. The current account has deteriorated progressively since the first quarter of 1987. Moreover, it is the visible trade balance component of the current account that has persistently deteriorated reaching a massive £6.3bn deficit in the fourth quarter of 1988 following earlier deficits of £4bn, £4.5bn and £5.6bn in the first second and third quarters, respectively. The balance on invisibles while falling in successive years after 1986 has not deteriorated as much as the visible account - a reduction of 33% for the former compared with a fall of 136% for the latter comparing 1988 with 1986. Furthermore, the deterioration in invisibles has not been progressive quarter by quarter as it has been for visibles. This is demonstrated by the increase in the surplus on the account to £1.8bn and £2.3bn in the second and third quarters of 1988. This was unfortunately followed by a fall in the fourth quarter producing an invisibles surplus of only £0.8bn.

The oil account component of visible trade has also been in decline more or less since the second quarter of 1987. However, a slight upward movement in the second quarter of 1988, to £0.82bn from £0.73bn in the first quarter, was followed by a marked fall to £0.46bn and £0.34bn in the third and fourth quarters. The effect of the Piper Alpha tragedy on oil production and exports is the principal reason for the reduced surplus in the second half of the year.

The January deficit on current account of £1.7bn was the third largest in history ie. £550m and £300m lower than the huge deficits recorded in October and July of last year. The current trends are therefore pointing to a £20bn deficit in 1989 if the January figures alone are extrapolated, or £18bn if the deficit of the last three months is projected forward. This is considerably higher than the Chancellor's forecast of £14.5bn which he announced in his Budget. This in turn was an upward revision of the forecast of a £13bn deficit contained in the Autumn Statement; a forecast which the December Commentary suggested might be an underestimate by some £1bn of £2bn. However, exports are on an upward trend and import volumes of consumer goods fell in January over December. The Treasury take this latter effect as being consistent with the slowing of UK consumer demand. It remains to be seen whether the necessary growth

of export to import volumes can be achieved during 1989 to the extent required to validate the government's current forecast. Moreover, the outlook for the exchange rate is increasingly uncertain.



In the final quarter of 1988 the output of the production industries, which accounts for 34.5% of GDP, is provisionally estimated to have been largely unchanged, falling by 0.2% over the previous quarter but attaining a level 2.6% above that achieved in the same period in 1987. The change in overall production output was depressed by the loss of production from Piper Alpha and associated fields. Output of the energy sector fell by 1.8% compared with the previous quarter to a level 7.5% below the same period a year earlier. Manufacturing output, in contrast, rose by 0.5% in the most recent quarter to stand 7% above the level of a year earlier. Within manufacturing, the principal increases recorded in the latest quarter were in other minerals where output rose by 3%, in other manufacturing by 2% and in chemicals by 1%. Output in the metals industry fell by 1% and was largely unchanged in engineering and allied, food, drink and tobacco, and textiles and clothing.

By market sector, the output of the consumer goods industries rose by 1% in the most recent quarter while, surprisingly, the output of the investment goods industries fell by 1.5%. This latter parallels the estimated fall in fixed investment during the second half of the year noted above. It is not unlikely that this figure too may be revised upward, although there still remains the possibility of a shift in favour of imported investment goods during the second half of last year.

The most recent data for production show that output continues to fall with a reduction of 0.5% in the three months to January compared with the previous three months. However, manufacturing output continued to rise, increasing by 1% over the preceding three month period, to a level 7% higher than the same period a year earlier. Output of investment goods industries remained little changed over the period.

THE LABOUR MARKET

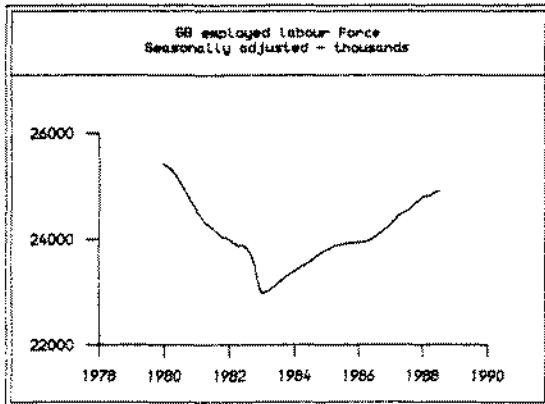
EMPLOYMENT AND UNEMPLOYMENT

The workforce in employment - which includes the employed labour force plus participants in work related government training programmes (see September Commentary) - is estimated to have risen by 120,000 in the third quarter of 1988. This can be compared with an estimated increase - on revised figures - of 39,000 in the second quarter and 114,000 in the first quarter. In the year to September the total estimated increase is 400,000. Within this figure, participants in training programmes rose by only 4,000, HM forces fell by 4,000, the self employed rose by 124,000 and employees in employment rose by 277,000.

Employees in employment rose by 48,000 in the third quarter of 1988, compared with increases of 106,000 and 8,000 in the first and second quarters of the year. The number of employees in the service sector rose by an estimated 76,000 between July and September, compared with estimates of 49,000 and 111,000 in the preceding two quarters. Employment in all other sectors fell in the third quarter. Manufacturing employment fell by 18,000, continuing the downward trend in that sector. However, recent data for fourth quarter employment change in manufacturing show a very small decline of only 1,000 jobs during the period. Energy and water continues to shed jobs with employment falling by 3,000 in the third quarter and by 5,000 in the final quarter of the year. Other industries also shed 6,000 jobs in the third quarter following a reduction of 8,000 in the second quarter following a reduction of 8,000 in the second quarter and an increase of 9,000 between January and March of last year.

Productivity - output per head - growth continues at a high level. The productivity growth figures for the whole economy during the first two quarters of last year have again been revised, but this time in a downward direction. The percentage

increase on a year earlier now stands at 3.5% and 3.2%, compared with the earlier estimates, reported in the December Commentary, of 4.1% and 3.8%. The estimate for the third quarter of 2.6% indicates a further slackening in the rate of productivity growth in the economy as a whole. In manufacturing, however, productivity growth has remained high and has if anything been increasing. During 1988, productivity growth rates over a year earlier were: 7.6%, 6.5%, 8.4% and 7.5% in each successive quarter. This is considerably higher than the rates achieved before the second half of 1986 when productivity growth in this sector improved considerably.



As noted in the consumer spending section above, the underlying increase in average earnings in the year to December was 8.75%, representing a fall from the peak annual increase of 9.25% which was reached in August and September. It cannot be guaranteed, however, that the rate of growth of earnings is now on a downward trend. Wage claims tend to reflect expectations of future inflation based on past experience of price inflation. It is therefore quite possible that we shall see rising wage inflation this year even though economic activity is turning down.

The rate of growth of unit labour costs in the whole economy has been revised upwards following the downward revisions in productivity growth. During the first three quarters of last year unit labour costs in the whole economy are now estimated to have grown by 5.3%, 5% and 5.7%, respectively. In manufacturing, the rate of growth of unit labour costs continues to be low, although there was a noticeable increase in December to 2.2% on a year earlier compared with an average 0.1% increase over a year during the

preceding five months. This appears to have been largely due to a reduction in productivity growth during that month.

The rate of decline in seasonally adjusted unemployment has picked up since we last reported. Then, over the six months ending October the monthly decline averaged, on revised figures, 40,800. In the subsequent three months, the average monthly fall over the previous six months was 43,100, 47,800, and finally, 46,500 in January of this year. By January, seasonally adjusted unemployment - based on the claimant count - stood at 1.988 million, or 7% of the workforce, down 49,300 on the previous month.

INDUSTRIAL RELATIONS

Three factors are likely to dominate industrial relations in 1989. First, a series of Government reforms of Labour legislation, training initiatives, wages councils and changes to employment conditions for public sector employees. Secondly, the continuation of moves to end centralised pay bargaining in the public sector and the spread of performance related pay schemes. Thirdly, employer initiatives to deal with the deepening shortages of skilled employees, and the tightening labour markets of the south and south east.

It is significant that recent Government proposals have attracted considerable criticism from all sectors. The publication of a Green Paper, heralding a fifth round of reform of labour legislation, has been seen as being prompted more by political expediency than employer need. The Paper proposes:-

1. Compensation of up to £8500 for those prevented from getting work because they are not members of a trade union. This is directed to reduce the impact of the pre-entry closed shop which remains a significant feature in shipping, docks, printing, and theatrical industries. The Green Paper additionally notes the Royal College of Nursing and British Medical Association as examples of pre-entry closed shops. As yet it is unclear as to whether this measure will give effect to employees having a right to choose which union they wish to join. Such a choice would run counter to much conventional wisdom in industrial relations of the need to minimise the problems of multi unionism.

2. Further limits on secondary action by revising the 1980 Act to make it unlawful for a union to induce workers to take secondary action other than by picketing at the place of the dispute.
3. Any pre strike ballot should include those who work under contracts of service, eg self employed and freelancing, as well as those under contracts of employment.

The Green Paper, in stressing the negative effect of the pre entry closed shop on jobs and productivity, relies heavily on the work of Metcalf who has estimated the closed shop adds 7% to wage costs. Metcalf's arguments are not widely accepted by fellow academics; there is much to criticise in his methodology and data. However, the use of questionable data and evidence has, unfortunately featured in a number of recent Government proposals, for example the London Survey in the White Paper 'Employment for the 1990s'.

The draft Code of Practice on trade union ballots before industrial action have met with widespread criticism. ACAS, the Institute of personnel Management and the CBI all agreed that the current proposals were confusing and unnecessarily prescriptive. The CBI saw a need to change the text so that it did not appear too onerous and prescriptive'.

Government proposals to abolish Wages Councils met similar criticisms and reservations. Whilst the Institute of Directors and employers organisations in the hotel, catering and licensed trades have supported such moves the CBI argued that wages councils can provide a useful role. Similarly the BIM described the proposals as unconstructive and unhelpful. The BIM echoed the traditional reasons for wages councils, namely the need to protect vulnerable poorly organised groups of employees. The IPM stressed the need for a more cautious approach, and argued that abolition should proceed on an industry by industry basis. It was not convinced by the conventional wisdom that national pay bargaining leads to higher wage rates being set than is the case under regional or local arrangements. Furthermore even the independent chairmen of wages councils have commented that the Government proposals are stronger on rhetoric and weaker on facts to support their proposals.

The Employment Bill, with proposals to end restrictions on the working hours of young people

and restrictions on womens' employment, attracted the least criticism, although concern was voiced as to the need for effective measures to ensure no exploitation of young people. These measures must be seen in terms of the growing concern about possible labour shortages.

Changes in employee relations policies, and especially moves to end industry wide bargaining arrangements surfaced widely in the public sector. British Rail reiterated its intention to end centralised pay bargaining in 1989. Evidence of a changed management attitude was well indicated by the proposals to by-pass unions and impose a package of pay related measures. Current proposals include regional allowances, performance related bonuses in the south east, and changes to shift patterns for maintenance staff. Collectively the proposals usher in a culture change for the railways and reflect the changes to work patterns and pay structures introduced in British Rail's catering division. In the face of such changes proposals for a merger between ASLEF and NUR surfaced once again.

In higher education, plans were announced to end industry wide bargaining for academic staff. It is clear that a number of universities were given a degree of informal encouragement to make offers independently of the national negotiations. Interestingly both the past settlement and current offer stress the need for some element of local discretion to award individual employees, a further version of performance-related pay.

The pay review body for nurses provided some insights as to the reasons for the nurses action over regrading which featured at the end of 1988. Much criticism was levelled at the Government's management of the regrading exercise. The Review Group noted that it was unfortunate that the Department of Health was unable to issue comprehensive guidance to health authorities until 6 months after the grading definitions had been agreed in negotiations. Elsewhere in the NHS the erosion of national pay bargaining and the spread of performance-related pay continues. Some 7000 NHS middle managers may witness the end of their pay bargaining arrangements and move to performance-related pay. Limited pay flexibility, based on regionalised pay and performance rewards, has been proposed for some 110,000 administrative and clerical staff.

The HMSO, in its new status as an executive

agency, has indicated an intention to move away from the Civil Service pay structure. The proposals include a new pay and grading structure, and, almost inevitably, a version of performance related pay.

A further feature in the public sector has been moves to reduce vulnerability to strike action by strategically placed employees. A number of proposals have been announced concerning computer staffs. The most recent being, Customs and Excise staff who face the choice of either accepting a no strike pledge or privatisation of computer services.

Evidence of moves towards de unionisation and altering bargaining structures are also discernible in the private sector. British Telecom has offered incentives to middle managers to accept personal contracts rather than collective bargaining. In communications and entertainment two television companies have withdrawn from the national bargaining arrangements.

An increasing awareness of possible and actual labour shortages have prompted a number of firms to seek alternative labour sources. Generally this has led to new schemes to employ women. Increasingly firms in the south east are considering the provision of creches and maternity breaks. Other proposals have included term-time contracts, for women with school aged children, policies for training older employees and renewed interest in job sharing. To attract young workers several firms have abolished youth training schemes and re introduced rate for wage payment structures, often with considerable increases in basic rates.

The trade union movement continues to face the difficult problems of adjustment to changed circumstances. The TUC is currently reviewing the structure and function of the annual congress. Proposals include replacing the annual congress with one every two or four years. Introducing a system of standing commissions to deal with specific policy areas, reducing the number of motions and debates. Merger discussions continue between the EEUPTU and AEU, agreement to merge has been reached between GBMATU and APEX.

PROGNOSIS

Evidence is mixed on whether growth in the economy

is beginning to turn down. Moreover, discrepancies in the national accounts, particularly with regard to gross domestic product GDP and balance of payments estimates, mean that we cannot be sure where the economy has recently been, never mind the direction it might go in the coming months. Despite the upturn in the provisional estimate of retail sales for February it can be expected that consumer demand will continue to moderate over the next few months. The Treasury's latest forecasts published on Budget day show that, in constant price or real terms, consumers' expenditure is expected to rise by 3.5% this year compared with 6.5% in 1988. Total domestic demand is expected to moderate from 6.5% last year to 2.5% this. And the growth of GDP is forecast to fall from last year's high of 4.5% to 2.5%.

What is of most immediate concern, however, is the outlook for the rate of inflation and the current account of the balance of payments. Inflation, currently running at around 7%, is forecast by the Treasury to peak in the middle of the year at 8%, falling back to 5.5% in the fourth quarter before reaching a 4.5% rate in the middle of next year. The current account is forecast to display a £14.5bn deficit in the current year, that is the same as the outturn for 1988. The macroeconomic significance of the Budget is whether the fiscal stance embodied within it, coupled with the government's interest and exchange rate policy, are sufficient to moderate the inflationary pressure without tipping the economy into recession.

The Chancellor's refusal to index excise duties suggests a concern about inflation bordering on panic which belies his stout defence of past economic policy and his general air of confidence about future prospects. That said, there clearly was a need for a tightening of the fiscal stance last year, in view of the rapid growth in domestic spending and an increasing private sector financial deficit. The fiscal stance was probably too lax in 1988 even though an unplanned Budget surplus - or public sector debt repayment (PSDR) - of £14bn was the outcome due to the rapid growth of the economy during the current - 1988/89 - financial year. The relatively lax fiscal stance in 1988, coupled with what in hindsight turned out to have been inappropriate interest rate reductions, undoubtedly contributed to the increase in price inflation and the deterioration on current account. The forecast of a £14bn PSDR

during 1980/90 suggests that the fiscal stance will remain broadly unchanged in the coming fiscal year. However, the irony is that this year that stance might now be too restrictive. The danger is that the Budget measures, coupled with a continuation of high interest rates, may force an improvement in the current account and a moderation of inflation by marked reductions in output and eventually employment: a hard rather than a soft landing.

With a relatively restrictive fiscal stance

bearing down on domestic demand, and the confidence of the foreign exchange markets maintained, the government now has scope to avoid demands for further interest rate rises. Once it is clear that demand in the economy has turned down the Chancellor should consider some downward movement of interest rates. This will not only help the balance of growth but will reduce the risk that the burden of reducing the current account deficit is borne by a contraction of output and employment.